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“Bonds 101”

Presentation to Texas Municipal League

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Overview

- Different Types of “Bonds”
- Important Features of “Bonds”
- Major Bond Market Players
- Top 10 Takeaways
- Questions?
- About Us - Norton Rose Fulbright US LLP

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Types of “Bonds”

Remind me again, what are “Bonds”?

- “Bonds” are basically promissory notes or evidences of indebtedness that may be referred to as “Bonds”, “Notes”, “Certificates”, or “Warrants”, depending on the statute authorizing their issuance.
- Issued by the State (and its agencies), counties, cities, school districts, and other public entities created under State law.
- Public entities can’t sell stock, so they sell debt in the form of Bonds and other types of public securities to finance their capital projects.
- Used to finance public-purpose projects—roads, bridges, utilities, hospitals, housing, economic development projects and more.

Types of “Bonds”*

Ad Valorem Tax-Backed Securities

General Obligation Bonds

Certificates of Obligation

Time Warrants

Tax Notes

Contractual Obligations

Refunding Bonds

Revenue-Backed Securities

Revenue Bonds

Time Warrants

Judgment Bonds

Lease Purchase Obligations

Refunding Bonds

* Not an exhaustive list.

General Obligation Bonds: Voter Authorized

- Secured by the City's ad valorem taxing power.
  - Supported by the full faith and credit of the city.
  - Viewed as one of an issuer's most secure obligations→ low interest rates.

- Generally, requires a bond election for authorization.
  - Governing Body calls this election and introduces proposition.
  - Voters will have to approve the proposition and the tax rate.
  - Tax rate to pay debt service is not subject to rollback.

- Once authorized by voters, Governing Body places matter on agenda and passes an ordinance authorizing sale of the GO Bonds.

- Must use the proceeds in accordance with the approved proposition ("contract with the voters").

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General Obligation Bonds: Voter Authorized (*cont.*)

- Can be issued for public projects as provided by Texas statutes, including (but not limited to):
  - Public buildings;
  - Waterworks, sewer systems, drainage;
  - Streets and bridges; and
  - Other purposes identified in the city's home rule charter: Chapter 1331 of the Texas Government Code.

- Can be amortized over no more than 40 year period.
  - Typically this period is less than 40 years.
  - Financial Advisor will structure Bond payments to meet the city's needs.

Certificates of Obligation: Streamlined Financing

- Secured by ad valorem taxes, revenues, or both.

- No election required to authorize (unless a petition is received).
  - Any petition must be signed by 5% of qualified voters.

- Cannot be issued if a bond proposition for the same purpose was rejected by voters in a bond election during preceding 3 years.

- May be issued to pay for:
  - Public improvements the city will own;
  - Purchase of materials, supplies, or other authorized needs;
  - Professional services (Financial Advisor, Bond Counsel, Engineer, etc.);
  - Demolition of dilapidated/dangerous structures; and
  - Restoration of historic structures.

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Certificates of Obligation: Streamlined Financing (*cont.*)

- "Notice of Intent to Issue" is required prior to issuance.
  - Published in a local paper on the same day of the week for two consecutive weeks at least 45* days prior to sale date.
  - Notice must specify:
    - (1) Time when authorizing order will be passed,
    - (2) The maximum amount and purpose(s) of the CO's,
    - (3) The source from which the COs will be paid,
    - (4) Other information about the city's outstanding debt

- Purposes can be combined (unlike GO Bonds).
- Tax rate to pay debt service is not subject to rollback (S.B. 2).
- Typically, projects funded by COs must be competitively bid.

* H.B. 477, 86th Legislative Session, changed the 30 day period to 45 days, effective September 1, 2019.

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Tax Notes: Short Term Financing

- Secured by ad valorem taxes; not subject to rollback (S.B. 2)
- <u>No election required</u> to authorize Tax Notes.
- Typically must be amortized over 7 years or less.
- May be issued to pay for:
  - Public improvements the city will own;
  - Purchase of materials, supplies, land, or other authorized needs;
  - Professional services (Financial Advisor, Bond Counsel, Engineer, etc.);
  - Operating or current expenses (“keep the lights on”);
  - A cash flow deficit
  - “Emergency” expenditures (**if** city is within 70 miles of the Gulf of Mexico).

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Tax Notes: Emergency Financing

- What is an "Emergency"?
  - Widespread damage from a Hurricane or Tropical Storm
  - Governor or the City Council have declared a state of disaster, or the Governor has proclaimed a state of emergency
- <u>No election required</u> to authorize Emergency Tax Notes
- Emergency Tax Notes can be amortized over <u>10 years</u> or less
- Emergency Tax Notes may be issued to pay for:
  - Employee salaries;
  - Lease of materials, supplies, land, or other authorized needs;
  - Demolition of dangerous structure/restoration of historic structures;
  - Economic development grants (not secured by ad valorem tax); and
  - Any purpose necessary to preserve and protect public health and safety.

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Public Property Finance Contractual Obligations

- Secured by ad valorem taxes, revenues, or both
- No election required to authorize PPFCOs
- No requirement to provide notice
- Can be amortized up to 25 years
- May be issued to pay for public property:
  - Vehicles;
  - Equipment; and
  - Machinery; but
  - NO land or capital improvements

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S.B. 2 Considerations

- Revenue Caps Under Senate Bill 2
  - Cities cannot raise tax revenue more than 3.5% without automatic rollback election, effective 2020 (previously 8%).
  - Existing capital leases and current expenses can put pressure against this revenue cap.
- <u>Consider Funding Current Expenses with Tax Notes or PPFCOs</u>
  - Purchase equipment or finance capital improvements with Tax Notes.
  - Purchase personal property with PPFCOs.
    - ad valorem taxes levied to pay debt are not subject to rollback calculation.

Other Types of Public Securities

Refunding Bonds

- Refinance outstanding Bonds.
  - Reduce interest costs of city.
- No election or publication required (limited tax bonds).
- Must be submitted for AG approval.

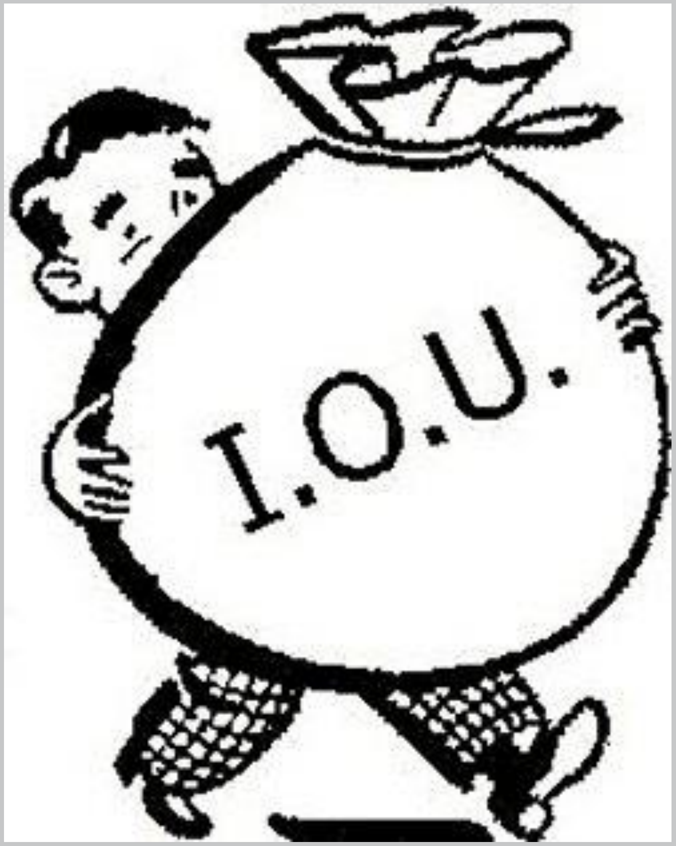
Time Warrants

- Secured by ad valorem taxes.
- Must publish “Notice of Intent” and subject to petition.
- Limited purpose and short maturity (<7 years).

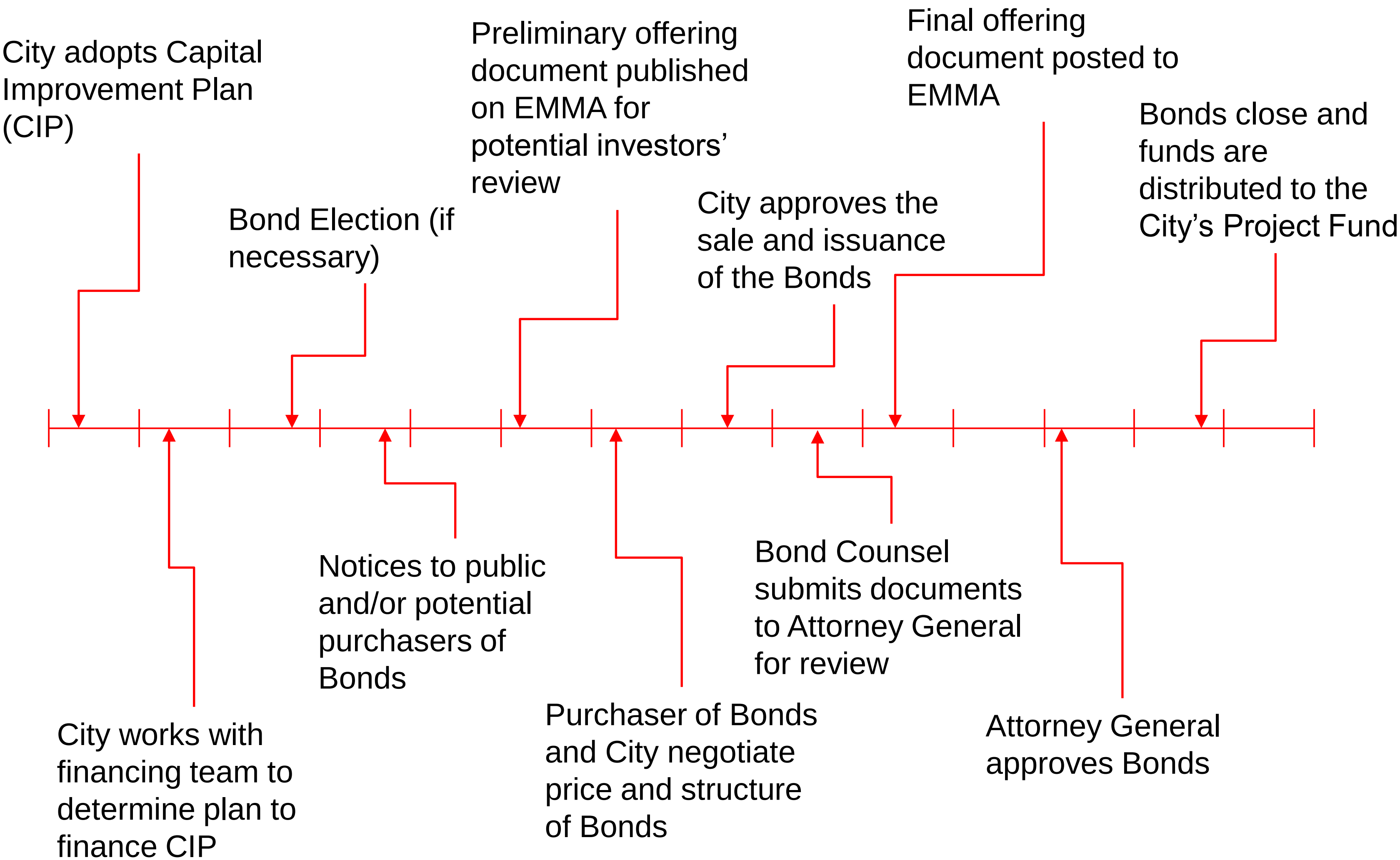
Revenue Bonds

- Secured by revenue stream (“enterprise fund”).
  - Utility System / Sales Tax (EDC)
- Debt service coverage ratio requirements (1.10 to 2.00).
- No Bond election required.

Important Things to Remember when Issuing "Bonds"



General “Bond” Issuance Timeline*



* The timeline will change based on type of “Bond” to be issued, type of sale (private bank placement, competitive/negotiated sale, and State law approval requirements. And, this, of course, would be different if the purchaser of the Bonds is the TWDB.

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Important “Bond” Concepts: Starting Points

- What is the city’s authority to issue “Bonds” under State law?
- Other limitations on city’s ability to issue “Bonds”?
  - Constitutional limitations?
    - Limitations on tax rate?
  - Truth-in-Taxation/Financial Considerations?
    - Will the payment of the Bonds be subject to rollback?
  - Attorney General limitations?
    - If someone says you don’t have to get AG approval, check with Bond Counsel.
    - Approval requires a detailed review of the bond transcript, but once approved securities will be uncontestable for State law purposes (absent constitutional defect or fraud on the AG).
    - Limitations on tax rate: the “Bond Allowable” test.
      - Depends on whether the City is a general law City (Type A, B, or C) or has adopted a Home Rule Charter.
      - General law cities must prove they can pay total Bond debt in any year with $1.00/$100 tax rate
      - Generally, home rule cities must prove they can pay total Bond debt in any year with $1.50/$100 tax rate

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Important "Bond" Concepts: Sources of Capital

- Open Market Financing (e.g., sell bonds)
  - Fastest and most efficient method of funding for the majority of projects.
- Texas Water Development Board
  - Has revolving loan programs for both sewer and water related projects;
  - Lending rate generally less than open market; and
  - Additional project and professional costs may be associated with this process.
- Grants: generally only available to lower income areas to provide basic service.
- Federal Agencies: generally targeted for rural or inner city programs.

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Important “Bond” Concepts: How are Bonds Sold?

- Competitive Sales
  - A sale that is conducted using sealed bids.
  - Basic terms and conditions are set by the city.
  - Bids are submitted in accordance with those terms.
  - Bid resulting in lowest effective cost for the city is chosen.
- Negotiated Sales
  - Issuer selects the underwriter(s) prior to the Bond sale.
  - Interest rates, underwriter compensation, and expenses are determined through negotiation with the underwriter.
- Private Placements
  - Interest rates are determined through negotiation with one or more investors.
  - These are usually banks or other institutional market participants.
  - “Committed lending period” is often limited.

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Important "Bond" Concepts: Tax Exemptions

- Most "Bonds" are issued on a tax-exempt basis.
  - Therefore the bondholder does not pay tax on interest income.
    - This is the main reason purchasers buy them, and why issuers receive a low interest rate.
    - A federal tax subsidy intended to benefit local government and <u>NOT</u> private industry.
- **However**, can lose exempt status→ Private Activity Bond.
  - Private Loan Test: If either 5% or $5M is loaned to a nongovernmental entity.
  - Private Business Test: If more than 10% of proceeds are used for private business and if more than 10% of the payment of the bonds may be secured by private trade or business.
- Therefore, consult with your Financial Advisor and Bond Counsel to make sure the intended uses of Bond proceeds will maintain tax-exempt status.

Important “Bond” Concepts: Securities Laws

- “Public Securities” are just that, securities.
  - Every bond offering includes facets of federal income tax, security (state and federal), and state law.
- These securities must follow securities law.
  - Often *exempt* from registration requirements.
  - Subject to anti-fraud provisions of both federal and state law.
- Consult with Bond Counsel

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You've Issued Bonds. What Comes Next?

Post-Issuance Disclosure

- After the issuance of publicly offered Bonds (e.g. not sold by private placement), a city will generally be obligated to provide annual disclosure in connection with the Bonds by making a "Continuing Disclosure Agreement" pursuant to S.E.C. Rule 15c2-12, which typically requires:
  - An annual report (including Audited Financial Statement and certain financial information prepared by your Financial Advisor or other consultant).
  - Notices of certain events, if and when they occur, during the year, within 10 business days of the occurrence.

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Post-Issuance Disclosure (*cont.*)

- Notice of Certain Events (summarized):
  - Late payments of principal and interest
  - Default for non-payment of principal and interest
  - Unscheduled draws on debt service reserves or credit enhancements reflecting financial difficulties
  - Substitution of credit or liquidity providers, or their failure to perform
  - Adverse tax opinions effecting tax-exempt status of Bonds
  - Changing the contractual rights of Bond owners
  - Bond redemptions or defeasances
  - Sale of property securing payment of Bonds
  - Rating changes
  - Bankruptcy or similar event
  - Merger, consolidation, or acquisition involving the sale of all or a substantial amount of the City's assets
  - Change of Paying Agent/Registrar
  - Incurring of a "Financial Obligation", if material, or amending a Financial Obligation that affects Bond owners
  - Default or modification of terms of a Financial Obligation that reflects financial difficulties

Post-Issuance Disclosure (*cont.*)

- What is a "Financial Obligation"?
  - Bank loans
  - Third-party capital leases
  - Variable rate obligations
  - Financial products that "operate as vehicles to borrow money"

- Tips for managing post-issuance compliance
  - Create a formal debt management policy
  - Identify and keep a list of outstanding debt and Financial Obligations
  - Develop a system to track financial difficulties
  - Designate a "compliance officer" to add new Financial Obligations when they are incurred
  - Work with your Financial Advisor and Bond Counsel

Bond Project Under Budget? Rules for "Excess"

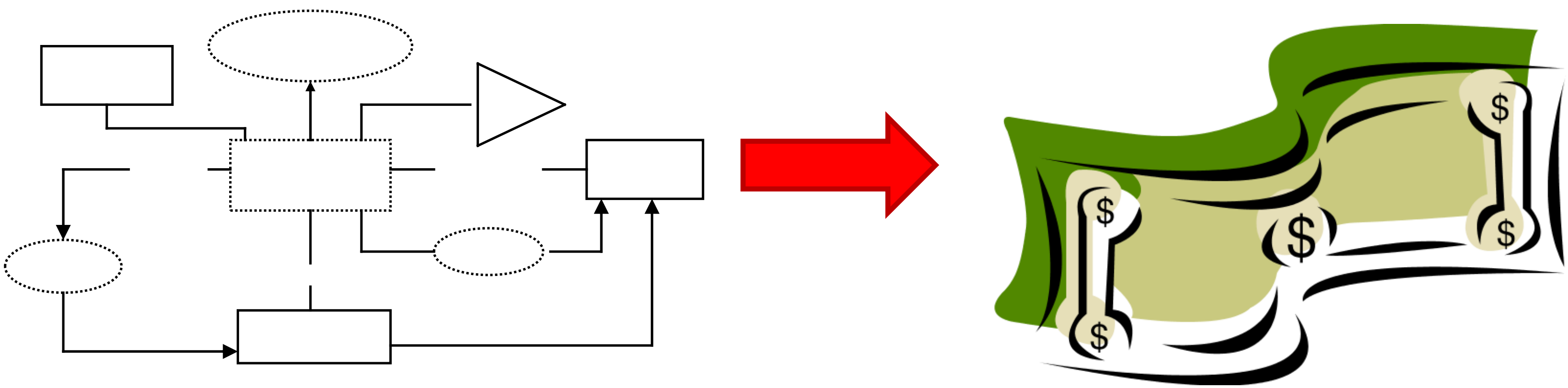
- State law perspective on excess proceeds
  - If a project comes in under budget and there are leftover proceeds, another project of the same type can be undertaken **if** the authorizing documents provide sufficient authority (bond order, election proposition, etc.).
    - i.e. if the bond proposition authorized general "street" work excess bond proceeds could be used to fix additional streets.
  - Excess proceeds can be used to pay off outstanding Bonds (usually not planned for and, therefore, expensive).
  - Work with Financial Advisor to "right-size" your Bond issuance.
  - Work with Bond Counsel to address possibility of unspent proceeds.

Excess:

Too much of a good thing?

It May Look Complicated…

But issuing public securities is like poetry—sometimes it's difficult to understand but it is beautiful when done right.



The Bond (Market) Actors

Bond Counsel

Financial Advisors

Credit Enhancement Companies

Underwriter

Underwriter's Counsel

Credit Rating Agencies

Bond Counsel:

A highly specialized attorney retained by the city to give a legal opinion that the city is authorized to issue the proposed public securities, the city has met all legal requirements necessary for issuance, and the interest on the proposed securities will be exempt from federal income taxation. They will prepare many of the documents used to issue the Bonds, including materials for a Bond election (if needed).

Bond Counsel works with the city and an attorney client privilege exists between the city and Bond Counsel. The city is Bond Counsel's client.

Financial Advisor:

A consultant who advises the city on matters pertinent to the Bond issue, such as structure, timing, marketing, fairness of pricing, terms, and Bond ratings. The Financial Advisor may also help prepare securities documents, including the Official Statement. They serve as the city's access to the market.

The Financial Advisor represents the city and its interests and owes a fiduciary duty to the city.

Credit Enhancement Companies

Organizations such as banks and insurance companies that lend their higher credit quality to the city, for a fee, and ensure service payments are made to purchasers of Bonds. Credit enhancement companies can (1) allow the city to issue Bonds at lower interest rates or (2) provide liquidity for variable rate obligations.

The most common example is a municipal bond insurance company. The city will pay an insurance premium in exchange for the insurance company guaranteeing the payment of principal and interest on the city's Bonds as they become due.

Underwriter

A dealer, or group of dealers, that purchase a new series of public securities. An underwriter can either hold the securities for their own benefit or resell the securities in the secondary market.

An underwriter may initially acquire the securities either through a competitive or negotiated sale.

While an issuer can work with an underwriter, they are ultimately <u>across the table</u> from each other. Each underwriter works to benefit its own interests and expects to make a profit from the transaction.

Underwriter's Counsel

A lawyer hired by the underwriters to represent them in purchasing and offering the Bonds. They will typically draft bond purchase agreements and may draft the offering document.

A cooperative environment between the city, bond counsel and underwriter's counsel generally exists. Underwriter's counsel sits <u>across the table</u> from the city and represent only the underwriter(s).

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Credit Rating Agencies

These companies rate the financial condition of the city and its ability to repay its Bonds. The three main credit rating companies are: S&P, Moody's, and Fitch. The issuer can contract with one or more rating agencies to assign a rating to the Bonds. These credit ratings may affect a public security's interest rate (higher rating→lower interest rate).

These credit rating agencies ultimately work for investors and <u>not</u> the city.

Top Ten Things to Remember about "Bonds"

The Top 10

10. There are many types of “Bonds”, with separate rules and requirements for each;

9. GOs almost always require an election before they can be issued;

8. COs do not require an election (absent a petition), but a notice of intent to issue must be published before they can be issued;

7. There are many parties to an issuance, only some of which sit on the same side of the table as (and therefore share an interest with) the city;

6. There may be constitutional, statutory, administrative, local, etc., limitations to city’s ability to issue debt and levy a tax;

5. Federal and State legislative and administrative changes (especially recently) impact an issuer’s ability to issue “Bonds”;

4. “Bonds” are typically tax-exempt, but can lose this status (private use);

3. “Bonds” must comply with certain securities laws;

2. There are rules governing how “excess” bond proceeds are spent; and

1. Bond work can be like poetry— sometimes difficult to understand, but beautiful when done right.

Any Questions?

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